

Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:CTR:HAR:TL-N-4257-99
CJSantaniello

date: AUG 11 1999

to: Chief, Examination Division, Connecticut-Rhode Island District
Attn: Bill Walsh, Case Manager, E:1507

from: District Counsel, Connecticut-Rhode Island District CC:NER:CTR:HAR

subject: Advisory Opinion - [REDACTED] & Subsidiaries

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We are responding to your request for advice received on July 1, 1999. For the reasons set forth below, we recommend that you not disallow the amortization deductions attributable to the [REDACTED] on the ground that its value is inseparable from goodwill. Instead, we recommend that you focus your efforts on challenging [REDACTED]'s assertions regarding the intangible's value and useful life.

This memorandum is being simultaneously submitted to the National Office for review under our post ten-day review procedure. Consequently, you should not take any action based on the advice contained herein during the 10-day review period.

Issues

1. Whether [REDACTED] is entitled under I.R.C. § 167(a) to amortize over [REDACTED] years the cost of a [REDACTED] (\$ [REDACTED]) entered into in conjunction with its \$ [REDACTED] acquisition of [REDACTED]'s [REDACTED] Division, under which agreement [REDACTED] agreed to be [REDACTED]'s "[REDACTED]" for certain product groups and [REDACTED] would be [REDACTED]'s "[REDACTED]" for those same products.

2. If the [REDACTED] is not amortizable under I.R.C. § 167(a), whether [REDACTED] may amortize the \$ [REDACTED] allocated to the agreement on a straight-line basis over a 15-year period by retroactively applying section 197, as provided under section 13261(g)(2), Omnibus Reconciliation Act of 1993, P.L. 103-66.

Facts¹

[REDACTED] was established in [REDACTED] as a wholly-owned subsidiary of [REDACTED] when [REDACTED] acquired [REDACTED]. From [REDACTED] [REDACTED] functioned as [REDACTED]'s [REDACTED] Division, consisting of three wholly-owned subsidiaries ([REDACTED], [REDACTED], and [REDACTED]). This operating division was a [REDACTED] manufacturer of high quality, [REDACTED] interior and exterior [REDACTED] components for [REDACTED]'s [REDACTED], [REDACTED] and [REDACTED]. [REDACTED] had manufacturing facilities in [REDACTED] (2), [REDACTED], and [REDACTED].

Before it acquired [REDACTED], [REDACTED] had traditionally relied on third-party vendors for virtually all of its [REDACTED] component needs. Following the [REDACTED] acquisition, however, [REDACTED] evolved from a supplier of solely [REDACTED] designed [REDACTED] into a [REDACTED] supplier of [REDACTED] components for all of [REDACTED]'s products. According to the [REDACTED] memorandum, "[v]irtually all of [REDACTED]'s current sales are to [REDACTED], [REDACTED]."

During the early [REDACTED], [REDACTED] manufacturers

¹ Many of the facts set forth herein are contained in a "[REDACTED] Memorandum" dated [REDACTED], prepared by [REDACTED] in connection with [REDACTED]'s sale of [REDACTED] to [REDACTED].

began to reduce their supplier bases, focusing on long-term, single-source contracts with their most reliable suppliers. According to [REDACTED], "[o]nce a producer has been designated to supply parts to a new program, [REDACTED] manufacturer will generally continue to purchase those parts from the designated producer for the life of the program." The memorandum further provides that "[REDACTED] will fully participate in the future performance of [REDACTED]'s new platform programs. [REDACTED] intends to introduce an average of [REDACTED] [REDACTED]."

On [REDACTED], [REDACTED] entered into an agreement with [REDACTED] to purchase [REDACTED]'s [REDACTED] Division, consisting of the three subsidiaries ([REDACTED], [REDACTED], and [REDACTED]). The closing took place on [REDACTED]. According to the documents provided by [REDACTED], the deal was structured as four separate sales, consisting of the following:

1. [REDACTED] purchased [REDACTED] percent of the stock of [REDACTED] from [REDACTED];
2. [REDACTED] and [REDACTED] entered into an agreement entitled "[REDACTED]" (discussed below in more detail);
3. [REDACTED] purchased [REDACTED]'s assets ([REDACTED] Division) via [REDACTED] and [REDACTED];
4. [REDACTED] and [REDACTED] entered into an agreement entitled "[REDACTED]."

As set forth in the closing documents, [REDACTED] and [REDACTED] allocated the \$[REDACTED] purchase price as follows:

Stock purchase price	\$ [REDACTED]
[REDACTED]'s assets	[REDACTED]
Total purchase price	\$ [REDACTED]

It is unclear whether [REDACTED] allocated any portion of the purchase price to goodwill. As indicated at page 15 of the Form 886A, Explanation of Items, [REDACTED]'s combined balance sheet

reflects total equity of \$[REDACTED].² According to the examination team, the \$[REDACTED] difference between this amount and the \$[REDACTED] purchase price of the stock may be attributable to the excess of fair market value over book value for various assets, including inventory, land, building, equipment, and goodwill/going concern. The examination team suspects that the portion of such excess attributable to goodwill/going concern is negligible.

For tax purposes, [REDACTED] treated its acquisition of [REDACTED] as a multiple purchase of stock, two separate supply agreements ([REDACTED]), and foreign assets. On its consolidated returns for [REDACTED] and [REDACTED], [REDACTED] claimed amortization deductions relating to the [REDACTED] of \$[REDACTED] and \$[REDACTED], respectively.³ The [REDACTED] deductions

² The balance sheet reflects the following:

ASSETS:

Cash	\$ [REDACTED]
Trade Accounts Receivable	[REDACTED]
Other Accounts Receivable	[REDACTED]
Net Inventories	[REDACTED]
Prepaid Expenses	[REDACTED]
Total Current Assets	\$ [REDACTED]
Land	[REDACTED]
Buildings and Equipment	[REDACTED]
Accumulated Depreciation	[REDACTED]
Net Property, Plant and Equip.	\$ [REDACTED]
TOTAL ASSETS	\$ [REDACTED]

LIABILITIES:

Trade Account Payables	\$ [REDACTED]
Employee Compensation and Taxes	[REDACTED]
Accrued Expenses	[REDACTED]
Total Current Liabilities	\$ [REDACTED]
Equity	\$ [REDACTED]
TOTAL LIABILITIES AND EQUITY	\$ [REDACTED]

³ Because the initial term of the [REDACTED] extended through the year [REDACTED], [REDACTED] assigned the intangible a [REDACTED]-year depreciable life (\$[REDACTED]). As discussed below, the agreement provides for the automatic renewal for subsequent [REDACTED]-year terms. Other evidence developed in this case demonstrates that the parties expected the customer/supplier relationship would continue indefinitely.

appear on [REDACTED]'s consolidated returns by [REDACTED] (\$ [REDACTED]), [REDACTED] (\$ [REDACTED]), and [REDACTED] (\$ [REDACTED]). The [REDACTED] amortization was deducted on the [REDACTED] portion of the consolidated return.

During the examination, the examination team asked the taxpayer to produce appraisals, if any, used to determine the fair market value of the three subsidiaries, the [REDACTED] assets, and the two supply agreements. Seven months later, on [REDACTED], the taxpayer provided the examiners with undated, in-house appraisals of the [REDACTED] and the [REDACTED]. According to those appraisals, the fair market values of those agreements are \$ [REDACTED] and \$ [REDACTED] respectively. However, the taxpayer has yet to produce an appraisal for either the stock or [REDACTED] assets to support its allocation of the \$ [REDACTED] purchase price to those assets.

To support your position (discussed below) that [REDACTED]'s \$ [REDACTED] payment for the [REDACTED] was, in substance, a payment for the sale of nonamortizable goodwill or going concern value, the IRS engineer valued [REDACTED]'s goodwill. Using [REDACTED]'s financial information received from [REDACTED], the engineer valued [REDACTED]'s goodwill at \$ [REDACTED].

As noted above, between [REDACTED] and [REDACTED], [REDACTED] and [REDACTED] had developed a mutually beneficial customer/supplier relationship, under which [REDACTED] was [REDACTED]'s only customer. Although there was no formal contract between the parties, the relationship was certainly relevant to [REDACTED]'s value as a going concern. In its Confidential Memorandum, [REDACTED] touted [REDACTED]'s long-standing supplier relationship with [REDACTED] as an indication of its value. The following excerpts from the memorandum are illustrative of [REDACTED]'s strength in the marketplace and its anticipated profitability based on its continued relationship with [REDACTED]:

Once a producer has been designated to supply parts to a new program, [REDACTED] manufacturer will generally continue to purchase those parts from the designated producer for the life of the program.
(Confidential Memorandum, p. [REDACTED])

⁴ This figure is approximately [REDACTED] times the value assigned to the agreement by the parties thereto.

A significant increase in profitability will be achieved in the near future as [REDACTED]'s major new [REDACTED] platforms move into full production and [REDACTED] continues to supply a significant portion of the [REDACTED] components and modular assemblies for these platforms. (Confidential Memorandum, p. [REDACTED])

[REDACTED] operates in a highly competitive, fragmented environment. Only a few [REDACTED] generate sales in excess of \$[REDACTED]. Even fewer [REDACTED] have the level of technology, experience, and experience in modular assembly and secondary-finishing operations that [REDACTED] maintains. The number of the Division's competitors is expected to decrease due to supplier consolidation. (Confidential Memorandum, p. [REDACTED])

[REDACTED] will fully participate in the future performance of [REDACTED]'s new platform programs. [REDACTED] intends to introduce an average of [REDACTED] [REDACTED]. (Confidential Memorandum, p. [REDACTED])

The [REDACTED] in this case was an absolute prerequisite to [REDACTED]'s acquisition of [REDACTED]. As reflected in the following excerpts from the agreement, the stock sale would not have occurred in the absence of the agreement:

All transactions contemplated to take place at the Stock Closing shall be deemed to have taken place simultaneously as a single transaction. (Closing Memorandum, p. 1) (Emphasis added)

[S]imultaneously with the execution and delivery of this agreement, [REDACTED] and [REDACTED] are executing and delivering that certain Stock Purchase Agreement dated the date hereof (the "Stock Agreement"). [REDACTED] recognizes that its execution, delivery and performance hereunder are fundamental to the decision by [REDACTED] to execute and deliver the Stock Agreement. (Agreement, p. 1) (Emphasis added)

[REDACTED] wishes to assure itself of a continued source of supply of certain products for use in [REDACTED] and in [REDACTED]'s manufacturing operations and to become a [REDACTED] customer of [REDACTED], as hereinafter set forth, with respect to the Products. (Agreement, p.2)

██████ wishes to assure itself of a customer for certain products in accordance with the terms provided herein and to become a ██████ supplier of ██████ with respect to the Products. (Agreement, p.2)

Evidence developed in this case strongly suggests that ██████ and ██████ intended that its customer/supplier relationship would extend indefinitely beyond the initial ██████-year term of the ██████. Relevant excerpts from the agreement and the Closing Memorandum on this point are as follows:

██████ is currently a long-term supplier to ██████ in certain products, and ██████ and ██████ are both interested in expanding the supplier relationship into one that is best described as "██████" with respect to the products. (Agreement, p.2) (Emphasis added)

██████ will purchase from ██████ and ██████ will manufacture and sell to ██████ ██████ percent (█████%) of the total quantity of Products authorized for release in ██████'s release system, from the date hereof through and including ██████ (or such lesser percentage as to dual sourced Products as shown on Exhibits A or B); provided, however that ██████ will purchase and ██████ will supply such percentage of the total quantity of Products for the life of the ██████ program using such Products, even if the program extends beyond the ██████. (Agreement, p.4) (Emphasis added)

██████ acknowledges that the purchase of the Purchased Companies by ██████ represents a significant investment and removal of one or more part numbers included in the Products could cause irreparable business damage to ██████. (Agreement, p.8)

██████ will be awarded replacement business for the Products provided ██████ meets ██████'s objectives for new programs. In such cases ██████ will not solicit or request competitive quotes from third parties for the purpose of sourcing such replacement business. (Agreement, p.10)

██████ will be ██████'s ██████ Supplier and ██████ will be ██████'s ██████ Customer for the Product Groups. (Agreement, p.11)

In addition to the above rights, and recognizing the magnitude, scope and critical importance to both parties of the Products defined in this Agreement, [REDACTED] and [REDACTED] will, during the term hereof, use reasonable efforts to assist each other to remain efficient and competitive and to foster a mutually beneficial long-term relationship. [REDACTED] is encouraged and expected to develop and submit proposals to [REDACTED] for additional business in order to assist [REDACTED] in attaining [REDACTED]'s objectives for Competitive Attributes. [REDACTED] agrees to negotiate a [REDACTED] agreement for fascia products with [REDACTED], which agreement would be substantially the same as this Agreement. (Agreement, pp.11-12) (Emphasis added)

This Agreement will automatically renew for successive [REDACTED] Year terms after the end of the [REDACTED], including such additional terms and modifications to the exhibits as mutually agreed and necessary, unless either party gives written notice at least [REDACTED] days prior to [REDACTED] or expiration of each such renewal term thereafter. (Agreement, p.22)

[REDACTED] is currently a long-term supplier to [REDACTED] in certain products, and [REDACTED] and [REDACTED] are both interested in expanding the supplier relationship into one that is best described as "[REDACTED]" with respect to the products. (Agreement, p.22)

[REDACTED] will purchase from [REDACTED] and [REDACTED] will manufacture and sell to [REDACTED] of the total quantity of Products authorized for release in [REDACTED]'s systems system, from the date hereof through and including [REDACTED]; provided, however that [REDACTED] will purchase and [REDACTED] will supply such percentage of the total quantity of Products for the life of the [REDACTED] program using such Products, even if such program extends beyond the [REDACTED]. (Agreement, pp.4-5)

Additional evidence of the parties' intent to renew the agreement indefinitely appears in the following passage from [REDACTED], [REDACTED]'s [REDACTED] letter to [REDACTED] regarding the supply agreement:

This arrangement would continue through the year [REDACTED] for all [REDACTED] with an evergreen renewal provision thereafter. (Emphasis added)

Relevant Law & Analysis

1. The disallowance of [REDACTED]'s amortization of the \$ [REDACTED] allocated to the [REDACTED] should not be predicated on the theory that the agreement is inseparable from goodwill or going concern value because in Newark Morning Ledger, 507 U.S. 546 (1993), the Supreme Court concluded an intangible asset that is proven to have value and wastes over an ascertainable period of time is amortizable, regardless of the fact that its value is related to the expectancy of continued patronage.

Under section 167(a), a taxpayer may deduct as depreciation a reasonable allowance for the exhaustion and wear and tear, including obsolescence, of property used in a trade or business or of property held for the production of income. Depreciation is intended to reflect the loss in value of an asset used to produce income and to make a meaningful allocation to the cost to the tax period benefitted by the use of the asset. Massey Motors, Inc. v. United States, 364 U.S. 92, 104 (1960).

An intangible asset may be depreciated or amortized if it is known from experience or other factors to be of use in the business or for the production of income for a limited period of time which can be estimated with reasonable accuracy. Treas. Reg. § 1.167(a)-(3). No deduction for depreciation is allowable with respect to an intangible asset, the useful life of which is not limited. Id. The regulation further provides that no deduction for depreciation is allowable with respect to goodwill. Id. A contract which has a limited life and is utilized in a trade or business may be amortized ratably over its useful life. Ithica Industries, Inc. v. Commissioner, 97 T.C. 253, 272 (1991) (involving the taxpayer-manufacturer's contract with a supplier for raw materials); Huffman v. Commissioner, 48 T.C. 176 (1967) (lease).

Goodwill is the aggregate value of the relationship and reputation developed by a business with its present and potential customers and associates over a period of time. Lorvic Holdings, Inc. v. Commissioner, T.C. Memo. 1998-281. It has been described as the "'expectancy of continued patronage.'" Newark Morning Ledger, 507 U.S. 546, 555-556 (1993), citing Boe v. Commissioner, 307 F.2d 339, 343 (9th Cir. 1962).

The standard for deciding whether an intangible is depreciable under section 167(a) was enunciated in Newark Morning Ledger, as follows:

[A] taxpayer [must] prove with reasonable accuracy that

an asset used in the trade or business or held for the production of income has a value that wastes over an ascertainable period of time.

Id. at 566 n.9. The availability of a depreciation deduction is primarily a question of fact, on which the taxpayer bears the burden of proof. Id. at 560, 566; FMR Corp., 110 T.C. at 430.

In this case, you propose to disallow the claimed amortization deductions on the ground that the supply agreement is, by its very nature, inseparable from goodwill or going concern value. According to the Form 886, Explanation of Items, the parties' allocation of a part of the purchase price to the agreement should not be respected because it is tantamount to goodwill.

Conversely, [REDACTED] maintains that it is entitled to amortize the \$ [REDACTED] allocated to the [REDACTED] under Newark Morning Ledger. According to the taxpayer, an intangible asset with an ascertainable value and limited useful life is depreciable under section 167(a), notwithstanding the fact that its value is related to the expectancy of continued patronage.

The relevant question in this case is not whether the supply agreement comes within the core concept of goodwill, as the district proposes, but whether it is capable of being valued and whether that value diminishes over an ascertainable period of time. For the following reasons, we believe that [REDACTED] is entitled to amortize the intangible in question, provided it can meet its burden of establishing that it has an ascertainable value and limited useful life ascertained with reasonable accuracy.

In Newark Morning Ledger, the Supreme Court described "goodwill" as "the expectancy of continued patronage." Id. at 555. It also stated, however, that such definition is of little assistance in trying to determine which intangibles are subject to amortization. Id. at 556. As the Court explained, "[t]he value of every intangible asset is related, to a greater or lesser degree, to the expectation that customers will continue their patronage [i.e., to goodwill]." Id. at 556-557. Consequently, the ultimate question is whether intangibles can be amortized even though they are related to the expectancy of continued patronage.

Whether a taxpayer succeeds in separating depreciable intangible assets from goodwill (i.e., by proving ascertainable value and limited useful life) in any particular case is a question of fact. Newark Morning Ledger, 507 U.S. at 564. If a taxpayer can demonstrate that the intangible in question wastes over an ascertainable period, "[t]he entire justification for refusing to permit the depreciation of goodwill evaporates." Id. at 565. Just as goodwill is not amortizable because it is not susceptible to wear and tear, a business asset should be deductible if it has an ascertainable value and wastes over an ascertainable period of time, "regardless of the fact that its value is related to the expectancy of continued patronage." Id. at 570; Wofford v. Commissioner, T.C. Memo. 1997-62. "The fact that an intangible may also be described as the 'expectancy of continued patronage' is entirely beside the point." Newark Morning Ledger, 507 U.S. at 556 n.9.

In Newark Morning Ledger, the Supreme Court added that the taxpayer's burden of proof is quite heavy and "often will prove too great to bear." Id. at 566. The taxpayer's burden in that case was significantly lessened by the government, which presented little or no evidence at trial challenging the taxpayer's calculations, choosing instead to rely on the legal argument that the amounts allocated to the intangible were indistinguishable from goodwill. The Supreme Court noted that the taxpayer's burden would have been much more difficult had the government presented evidence challenging that offered by the taxpayer.

To summarize, in Newark Morning Ledger, the Supreme Court conclusively rejected the government's definitional goodwill theory, instead concluding that to amortize an intangible asset under pre-§ 197 law, a taxpayer must satisfy two (and only two) requirements. First, the intangible must have an ascertainable value. Second, the intangible must have a limited useful life. Accordingly, if [REDACTED] is able to establish both requirements, it may amortize the [REDACTED] notwithstanding the fact that its value is related to the expectancy of continued patronage. Considering the Supreme Court's emphasis on the heavy burden facing taxpayers in meeting these requirements, we recommend that the examination team focus its efforts on challenging [REDACTED]'s assertions regarding value and useful life.

In this case, [REDACTED] paid [REDACTED] \$[REDACTED] for the [REDACTED]. The fact that this amount approximates [REDACTED]'s goodwill (\$[REDACTED]), as determined by the Service's

engineer, is not controlling because the issue involves the contract's value, as opposed to whether it can be separated from goodwill. Newark Morning Ledger.

To date, the only appraisal obtained regarding the supply agreement belongs to the taxpayer. This agreement reflects a value of approximately \$ [REDACTED] almost [REDACTED] times the amount allocated by the parties to the contract. This value was determined based on the present value of the future earnings anticipated under the agreement. Whether this is the correct methodology is a matter for our engineer or appraiser. However, the fact that [REDACTED] sold all of the assets for \$ [REDACTED] strongly suggests that the taxpayer's appraisal is grossly inflated. In any event, we recommend that Examination secure its own appraisal of the contract.

We believe that there are several factors that may affect the value of the supply agreement. First, the contract was as valuable to [REDACTED] as it was to [REDACTED]. From [REDACTED], the [REDACTED] supplied [REDACTED] with virtually all of its [REDACTED] components. Consequently, [REDACTED] was unwilling to sell [REDACTED] to an unrelated third-party without some assurance that its longstanding relationship with the its reliable supplier would continue. Similarly, [REDACTED] was a single-customer company, which posed significant risks for any buyer. As the parties unambiguously expressed in the agreement, [REDACTED] wished to assure itself of a continued source of supply and [REDACTED] wished to assure itself of a customer. (Agreement, p.2) It is, therefore, understandable why [REDACTED] recognized in the agreement that its execution, delivery, and performance under the agreement were fundamental to the decision by [REDACTED] to execute and deliver the Stock Agreement. (Agreement, p. 1) Because the contract was mutually beneficial, it is questionable why [REDACTED] paid [REDACTED] \$ [REDACTED] for the agreement.

It is also arguable that the supply agreement was not necessary. Although the companies wanted to assure themselves of a continued customer/supplier relationship, the facts suggest that the relationship would have continued even in the absence of an agreement. In its confidential memorandum, [REDACTED] exalted [REDACTED]'s future profitability based on its supplier relationship (where there was no contract) with [REDACTED]. In the early [REDACTED], [REDACTED] began to focus on long-term, single-source contracts with their most capable suppliers. Because of its existing relationship with [REDACTED], [REDACTED] (and [REDACTED]) fully expected [REDACTED] to remain the [REDACTED] supplier indefinitely for all of its product lines.

The facts also demonstrate that [REDACTED] intended to introduce an average of [REDACTED].

We further recommend that you issue a summons commanding [REDACTED] to produce for inspection all appraisals obtained in connection with [REDACTED]'s acquisition of [REDACTED]. We find it difficult to believe that [REDACTED], a large public corporation, did not obtain appraisals for the [REDACTED] stock and the [REDACTED] assets. Due diligence would have certainly compelled such action in connection with a \$[REDACTED] acquisition of a single-customer company.

We may also contest [REDACTED]'s determination that the [REDACTED] had a useful life of only [REDACTED] years. It is well settled that where a contract is renewable as a matter of course, it will generally be considered to have an indefinite useful life and, therefore, not to be an asset subject to amortization. Triangle Publications, Inc. v. Commissioner, 54 T.C. 138 (1970).

In this case, the agreement provides at Article 3 that "[REDACTED] will purchase from [REDACTED] and [REDACTED] will manufacture and sell to [REDACTED] percent ([REDACTED]%) of the total quantity of Products authorized for release in [REDACTED]'s release system, from the date hereof through and including [REDACTED]." The agreement further provides in Article 13 that it would automatically renew for successive [REDACTED] terms after the end of the [REDACTED] unless terminated by either party by serving written notice within the time frames set forth in the agreement. Although subsequent renewals were not guaranteed under the agreement, the following passage from [REDACTED] letter to [REDACTED] strongly suggests that perpetual renewals were anticipated:

This arrangement would continue through the year [REDACTED] for all [REDACTED] with an evergreen renewal provision thereafter. (Emphasis added)

The Examination Division alternatively maintains, citing Gregory v. Helvering, 293 U.S. 465 (1935), that the transaction, structured as the sale of [REDACTED] separate assets, should be recharacterized and taxed in accordance with its substance. Specifically, Examination maintains that the entire \$[REDACTED] paid for the [REDACTED] was a disguised payment for the [REDACTED] stock. From this, Examination concludes that the entire \$[REDACTED] should be allocated to the stock.

It is well established that simply because a taxpayer pays or allocates a specific amount to an intangible asset is not controlling for federal income tax purposes. Lemery v. Commissioner, 52 T.C. 367, 375 (1969), aff'd per curiam, 451 F.2d 173 (9th Cir. 1971). The court will strictly scrutinize an allocation if it does not have adverse tax consequences for the parties because adverse tax interests deter allocations which lack economic reality. Wilkof v. Commissioner, 636 F.2d 1139 (6th Cir. 1981), aff'g per curiam, T.C. Memo. 1978-496; Haber v. Commissioner, 52 T.C. 255, 266 (1969), aff'd per curiam, 422 F.2d 198 (5th Cir. 1970). The court will also go beyond the formalities delineated by the parties to ascertain if the form reflects the substance of those dealings. Yandell v. United States, 315 F.2d 141, 142 (9th Cir. 1963); Annabelle Candy Co. v. Commissioner, 314 F.2d 1, 5 (9th Cir. 1962), aff'g per curiam, T.C. Memo. 1961-170.

In order for the form in which the parties have cast their transaction to be respected for federal income tax purposes, the allocation/payment in question must have some independent basis or an arguable correlation to business reality such that reasonable people might bargain or contract for such an agreement. Schultz v. Commissioner, 294 F.2d 52, 55 (9th Cir. 1961), aff'g 34 T.C. 235 (1960); Lorvic Holdings, Inc. v. Commissioner, T.C. Memo. 1998-281. This particular test is referred to as the "economic reality" test. Patterson v. Commissioner, 810 F.2d 562, 571 (6th Cir. 1987), aff'g T.C. Memo. 1985-53. An allocation to an intangible asset⁵ lacks economic reality if there is no rational basis for acquiring it. Even if the test is passed, fair market value must still be established.

It is arguable that the supply agreement lacks business reality because it was unnecessary. As explained above, [REDACTED] (the purchaser) needed [REDACTED] (the supplier) as much as [REDACTED] needed [REDACTED]. Although the companies may have wanted to assure themselves of a continued customer/supplier relationship, the facts strongly suggest that the business relationship between [REDACTED] and [REDACTED] would have continued following [REDACTED]'s acquisition of [REDACTED] even in the absence of an agreement. As previously discussed, it was customary practice in the [REDACTED] industry that, once a supplier has been designated to supply parts to a new program, [REDACTED] manufacturer will generally continue to purchase those parts from the designated producer for the life of the program.

⁵ Although most cases involving the economic reality test involve covenants not to compete, the same principles apply to all intangibles. See Lorvic Holdings.

Whether the relationship between [REDACTED] and [REDACTED] would have continued following the acquisition in the absence of a formal agreement requires additional development.

Whether the \$ [REDACTED] paid by [REDACTED] for the supply agreement lacks economic reality depends on the value of the other assets acquired by [REDACTED] as part of the \$ [REDACTED] acquisition. If the value of the stock and assets acquired by [REDACTED] substantially exceed \$ [REDACTED], it would tend to establish that the \$ [REDACTED] paid under the supply agreement lacks economic reality. If, on the other hand, the combined value of the stock and assets is less than the \$ [REDACTED], the agreement may have some value, depending on the amount of the difference. We, therefore, recommend that the Examination Division secure appraisals for the stock and assets to determine this critical fact.

2. [REDACTED] may not depreciate the \$ [REDACTED] allocated to and paid for the [REDACTED] straight-line over a 15-year period by retroactively applying section 197, as provided for in section 13261(g)(2), Omnibus Reconciliation Act of 1993, P.L. 103-66.

As previously discussed, before 1993, an acquired intangible asset could be depreciated only if held for use in a trade or business and if the taxpayer could demonstrate with reasonable accuracy that the intangible had a limited useful life. To eliminate the controversy surrounding the treatment of goodwill and certain other intangibles, Congress enacted section 197 as part of the Omnibus Reconciliation Act of 1993 (OBRA 93). P.L. 103-66, sec. 13261(a), (g), 107 Stat. 532, 540.

Section 197(a) generally provides for a straight-line amortization deduction with respect to any "amortizable section 197 intangible" over a fifteen-year period beginning with the month in which such intangible was acquired. The term "amortizable section 197 intangible" means any "section 197 intangible" acquired by the taxpayer after August 10, 1993 and used in a trade or business. The term "section 197 intangible" includes, among other things, goodwill, going concern value, customer-based intangibles. Section 197(d)(1)(A), (B), (C)(iv). The term "customer-based intangible" is defined to include the value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business to customers.

Section 197 generally applies to assets acquired after August 10, 1993, the date of enactment. One exception to this rule, however, appears in OBRA 93, section 13261(g)(2), as amended by The Small Business Protection Act of 1996, P.L. 104-188, § 1703(1). Under that exception, taxpayers may elect to apply section 197 to assets acquired after July 25, 1991, the date legislation similar to section 197 was first introduced. OBRA 93, section 13261(g)(2); H.Res. 292, 102d Cong., 1st Sess., 137 Cong. Rec. H. 11317 (1991).

An election to retroactively apply section 197 must be made on the taxpayer's timely filed (including extensions) income tax return for the taxable year that includes August 10, 1993. Temp. Treas. Reg. §§ 1.197-1T(b)(4), (5), (c)(3). If, however, the taxpayer's original federal income tax return for the election year is filed before April 14, 1994, the election may be made by amending that return no later than September 12, 1994. Temp. Treas. Reg. § 1.197-1T(c)(3)(i). The requirements for inclusion in the election statement are set forth in Temp. Treas. Reg. §§ 1.197-1T(e)(2)(i) through (vi) and (ix).

Section 197 does not apply to the assets in this case because they were acquired prior to the date of enactment. Lorvic Holdings, Inc. v. Commissioner, T.C. Memo. 1998-281. Additionally, it does not appear that [REDACTED] retroactively elected to apply section 197 to the intangible property acquired from [REDACTED] on [REDACTED] because it did not file an election statement with either its original [REDACTED] return or amended return for that year.

Under Treas. Reg. § 301.9100, however, the Service has discretion, upon a showing of good cause by the taxpayer, to grant a reasonable extension of time fixed by the regulations for making an election, provided:

1. the time for making the election is not expressly provided by law;
2. the request for extension is filed with the Service within a period of time the Service considers reasonable under the circumstances; and
3. it is shown to the Service's satisfaction that granting an extension will not jeopardize the government's interest.

Treas. Reg. § 301.9100-1(a).

In Rev. Proc. 79-63, 1979-2 C.B. 578, the Service announced that the following five factors will generally be considered in determining whether good cause has been shown and the other requirements have been met:

1. Due diligence of the taxpayer;
2. Prompt action by the taxpayer;
3. Intent of the taxpayer;
4. Prejudice to the government's interests; and
5. Statutory and regulatory objectives.

In this case, [REDACTED] has not requested administrative relief under Treas. Reg. § 301.9100. Because there is no time limitation imposed for applications thereunder, the taxpayer may request relief at any time. Accordingly, the taxpayer may litigate the threshold issue in this case (i.e., [REDACTED] and, if unsuccessful, apply for administrative relief under Treas. Reg. § 301.9100.

We are presently without sufficient information upon which to determine whether relief, if requested by the taxpayer, would be granted in this case. However, considering the significant time lapse since the filing of the taxpayer's [REDACTED] return, there is some question whether the taxpayer would be able to sustain its burden of demonstrating reasonable cause for the delay.

Conclusion

Based on the Supreme Court's holding in Newark Morning Ledger, the Service should not disallow the claimed amortization deductions attributable to the supply agreement on the ground that the value of the agreement is inseparable from goodwill. Instead, we recommend that the examination team focus its efforts on challenging [REDACTED]'s assertions regarding the intangible's value and useful life. Additionally, although [REDACTED] could have elected to amortize the \$[REDACTED] over a 15-year period by retroactively applying section 197, it did not elect to so. Furthermore, there is insufficient information upon which to determine whether [REDACTED] is entitled to administrative relief under Treas. Reg. § 301.9100. However, you may wish to consider the possibility that the taxpayer could be granted relief under this section if there is some chance you can resolve this issue with the taxpayer.

Please call Carmino J. Santaniello of this office at (860) 290-4075 if you have any questions or require additional information.

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